United States Court of Appeals
for the Second Circuit

BRIEF FOR APPELLEE

74-1166

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FOR THE SECOND CIRCUIT

PHILIP HANDELMAN and ESTHER HANDELMAN,

Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEES

ROBERT M. TRIEN
Attorney for Appellees,
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New York, New York 10017

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COUNTER STATEMENT OF THE ISSUES PRESENTED

The Plaintiff-Appellees (hereinafter called the taxpayer) disagrees with the Appellant's statement of the issues to the extent that he claims that there is an issue as to whether the Tax Court was correct in allowing the taxpayer to report $95, 000 in payments received by him in accordance with the installment method of accounting. The Commissioner, in the ninety day letter which precipitated the proceeding below made no determination with respect to the applicability of the Internal Revenue Code provisions respecting the reporting of income on the installment basis pursuant to Section 453(B) of the Internal Revenue Code of 1954.[1] Neither was that issue listed in the statement of issues presented in the original brief submitted by Appellant to the Tax Court. Neither was such an issue even adverted to in the memorandum findings of fact and opinion, or the decision of the Tax Court (R. 152-176,180).[2]

1. In the deficiency letter, the Commissioner determined that the $95, 000 received by the taxpayer in 1961 through 1963 is taxable as ordinary income in the year 1963 "when a contract to sell certain shares of Graphic Arts Exhibits Building, Inc. stock was held to be in final default" (R. 16).

2. Parenthetical numerical reference, preceeded by "R", are to pages in the appendix; parenthetical numerical references preceeded by "Ex. Vol." are to pages in the separately bound exhibit volume.

COUNTER STATEMENT OF THE CASE

The statement of the case presented by the Appellant is replete with erroneous factual claims and is extremely misleading in relation to the basic transactions which are here involved. Contrary to the confused presentation made by Appellant, the Tax Court, in its opinion, sets forth the facts with clarity and points out that "the facts are not subject to dispute" (R. 165). Those facts, as reflected by the undisputed evidence and as summarized by the Tax Court, are as follows:

In 1961, taxpayer obtained a concession to erect a building to house exhibits relating to the Graphic Arts Industry, at the 1964-1965 World's Fair, having obtained a committment for the leasing of land at the World's Fair site (R. 165, 55). To that end, the taxpayer, an attorney, formed Graphic Arts Exhibits Building, Inc. and the company put out a brochure with a drawing of the proposed building, and obtained the committment from the World's Fair allowing it to put up the building on a specific lot and block at the Fair (R. 55; Ex. Vol., 33). An advisory committee was established for the building, on which served various persons, including Bennett Cerf, Cass Canfield, Arnold Gingrich and others prominent in the publishing field (R. 56). The taxpayer and the other principals in the corporation explored the interest of persons and organizations in the

Graphic Arts industry to exhibit in the building, and sought to hire a renting agent to actually lease out the building space (R. 56). Thomas O'Connor expressed an interest in becoming the renting agent and in June of 1961 entered into an agreement with the corporation pursuant to which he was to receive certain compensation and a small stock interest, and was also to provide approximately $100,000 as working capital (R. 56). A short time later, Mr. O'Connor and his partner, Mrs. Joan Vande Maele, decided to acquire all of the stock in the corporation. In or about August 1961, Mr. O'Connor and Mrs. Vande Maele agreed to purchase the taxpayer's stock interest for $221,000 making an initial payment of $25,000 on August 30, 1961. Vande Maele and O'Connor eventually paid the taxpayer a total of $95,000 and gave the taxpayer various notes aggregating $126,000 on account of such agreement (R 69).[3] Two of the three notes making up the balance of the $221,000 purchase price were executed by Mrs. Vande Maele on December 8, 1961, and were payable on June 8, 1962

3. A dispute between the taxpayer and the Commissioner as to the timing of the receipt of these payments was resolved by an agreement that for the purpose of this lawsuit, the $25,000 was received and reported in 1961, $40,000 was reportable in 1962 and $30,000 was "deemed" to be taxable in 1963 (R.111).

in the respective amounts of $50, 000 and $17, 000. Also on December 8, 1961, VandeMaele and O'Connor executed a note in the amount of $48, 000 payable to Dr. A. Alfred Solomon, another shareholder in Graphic Arts (R. 155, 156; Ex. Vol. 42, 55-56), whose stock was also being purchased by VandeMaele and O'Connor.

VandeMaele and O'Connor defaulted on the notes which were payable on June 8, 1962 to taxpayer and Dr. Solomon (R. 156). There followed this default various written escrow agreements which were entered into by the taxpayer on behalf of himself, and in certain cases other Graphic Arts stockholders, including Dr. Solomon, pursuant to which the Graphic Arts stock was made available to the purchasers upon payment of the notes, the time for payment being in each case extended. In an agreement dated June 13, 1962, between taxpayer and O'Connor, taxpayer agreed to turn over Graphic Arts shares in the event that notes totaling $115, 000 (including the $48, 000 note payable to Dr. Solomon), which were then in default, were paid by June 15, 1962. A total of 88 shares were to have been turned over upon payment of those notes and the payment of an additional note of $59, 000 (R. 157).

The $95, 000 initially paid to taxpayer, plus the three notes referred

to in the escrow agreements in the respective amounts of $50,000, $17,000 and $59,000, total the $221,000 which VandeMaele and O'Connor had agreed to pay for taxpayer's stock.

The closing date on the June 13, 1962 agreement was extended again, by letter, to July 11, 1962 (R. 77).

The second escrow agreement is dated March 14, 1963, and provides for the delivery by the taxpayer of Graphic Arts shares upon payment to the taxpayer of $150,000 which includes the $126,000 owed to him on the three notes which were then in default, plus an additional $24,000 which the purchasers had agreed to pay for the stock. [4]

The third escrow agreement is dated March 20, 1963. The payments to be made pursuant to this agreement are exactly the same as previously stated, this agreement providing for a closing date of March 25, 1963. The net effect of all of these escrow agreements was to give the purchasers various extensions of time to pay the balance of the purchase price of the stock, since after the initial default, the tax-

4. This agreement also provides for a payment to Raymond Barger for certain shares owned by him.

payer had the right to rescind the agreement to sell the stock. In addition, the escrow agreements were for the purpose of facilitating the purchasers attempts to borrow funds to pay for the stock in accordance with the original agreement. As appears from the agreements, the purchasers were thus assured of the delivery of shares of stock upon the payment of various notes, the taxpayer having delivered the stock to a bank officer, who was named as escrow agent, which officer was to deliver the stock to the purchaser upon the payment of the notes (R. 78).

After the last escrow agreement expired by its terms on March 25, 1963, the stock was again placed in escrow in Dallas, Texas, where the purchasers represented that they were obtaining funds to discharge their obligations under the aforesaid notes and their 1961 agreement (R. 57-8).

Because of the purchasers' failure to make the payments in accordance with their agreement and promissory notes, the taxpayer sued the purchasers in the Supreme Court, New York County. Taxpayer also sued the purchasers on behalf of Dr. Solomon. The case on behalf of Dr. Solomon was the first to be decided. The New York State Supreme Court, Appellate Division, First Department in a decision reported at

21 AD 2d 316, 250 N.Y.S. 2d 772 (1964), awarded summary judgment to Dr. Solomon. That decision, as well as the decision of Justice Vincent Lupiano of the New York Supreme Court, who granted a summary judgment in the taxpayers suit have importance in this situation in that the Commissioner has taken the position that these cases were based solely on the notes, unrelated to any underlying agreement to purchase the stock, the Commissioner further contending that each of the notes given to the taxpayer, and each of the escrow agreements, were separate transactions unrelated to the underlying agreement to purchase the stock. To the contrary, the New York State Appellate Division, at 250 N.Y.S. 2d, page 773, granting summary judgment to Solomon, stated:

> "While the original agreement to purchase the stock was never entirely reduced to writing, there are several letters and documents signed by the defendants, or one of them, confirming the fact of an agreement to sell and the placing of the stock in successive escrows to assure its delivery upon payment of the price."

Each of the escrow agreements referred to above, rather than constituting successive new agreements to purchase the stock, were merely entered into by the taxpayer for the purpose of facilitating the loaning of

money by the purchasers for the purpose of paying the agreed price, such escrow agreements giving assurance to the purchasers that although they had previously defaulted, they would receive the stock if the money was paid at the newly stipulated time. As is pointed out by the Appellate Division in 250 N. Y. S. 2d, at page 775:

> "After they had defaulted . . . plaintiff could refuse to deliver the stock at least after a reasonable time had elapsed. (Personal Property Law § 132, 134, 141.) . . . By this new (escrow) agreement plaintiff gave up his accrued remedies as an unpaid seller, including the right to resell the stock, and defendants obtained the right to purchase the stock they desired within another two months."

In the decision of Judge Lupiano of the New York Supreme Court, in which summary judgment was awarded to the taxpayer in his suit on the notes, it is stated:

> ". . . The defendants here urge the additional defenses of no consideration, and that in the event of nonpayment of the notes the stock was to be redelivered by the escrowee and held by plaintiff as the owner thereof. In effect, it is contended that there was in fact no sale. These defenses are integrated with those considered by the Appellate Division in the companion action, (brought by Solomon) and as there stated, these defenses are also commercially incredible."

Thus, the successive escrow agreements were not separate transactions pursuant to which any agreements to purchase stock were made, but rather, were merely agreements to waive the default under the 1961 agreement and to deliver the stock although the purchasers were late in paying the purchase price.

With respect to the Commissioner's claim that there was no "sale", and that the sums received by the taxpayer were not in connection with any "sale" of stock, it is to be noted that Judge Lupiano held to the contrary. He stated in decision appearing in the New York Law Journal on October 21, 1965:

> "In effect, it is contended (by Van de Maele and O'Connor) that there was in fact no sale. These defenses are integrated with those considered by the Appellate Division in the companion action, and as there stated, these defenses are also commercially incredible."

Thus, the escrow agreements, rather than being separate agreements to purchase, were merely agreements to waive the prior defaults and were viewed by both the Appellate Division and Judge Lupiano as evidence of the underlying agreement.

In an order dated December 7, 1965, Justice Lupiano granted summary judgment against the purchasers, holding them liable on the three notes sued upon in the total amount of $126, 000 (Joint Exh. 14-N). Five years later, by stipulation entered into on April 14, 1970, (Ex. Vol. 20-22) the outstanding judgment was compromised by the purchasers' payment of $89, 500, and the Petitioner's turning over of certain documents, including the various certificates representing the shares of Graphic Arts Exhibit Building, Inc.

SUMMARY OF ARGUMENT

The Commissioner contends that the $95,000 received by the taxpayer was "in the nature of liquidated damages" (Commissioner's brief page 12), and that as such, should be treated as ordinary income. In effect, the Commissioner contends that the taxpayer was entitled to keep the sums received by him as liquidated damages, as well as keeping the stock. Taxpayer contends that this is not so under New York law, and that in the absence of an express agreement pursuant to which the sums received by him were to be treated as liquidated damages entitling him to keep both the payments and the stock, taxpayer was in the position of any unpaid seller who had the option of either giving back the sums received by him and rescinding the sale or affirming the agreement to sell the stock by keeping the sums received by him and suing for the unpaid balance. He chose the latter course. The sums received by him, therefore, were for the "sale" of his stock, and are reportable as capital gains.

POINT I

THE PAYMENTS RECEIVED BY THE TAXPAYER DID NOT CONSTITUTE A FORFEITURE, BUT RATHER WERE PARTIAL PAYMENTS FOR THE SALE OF STOCK WHICH THE TAXPAYER IS ENTITLED TO TREAT AS A CAPITAL GAIN.

At the relevant period, the sale of stock under New York Law was governed by the Sales Act (Personal Property Law, Sec. 82, et seq.) See Rosenzweig v. Salkind, 6 Misc. 2d 284, 158 N.Y.S. 2d 522, reversed on other grounds, 5 A.D. 2d 58, 169 N.Y.S. 2d 213, aff'd., 5 N.Y. 2d 902, 183 N.Y.S. 2d 82; Bishop v. Tracy, 237 A.D. 496, 261 N.Y.S. 2d 463. That statute specifically provides rules for determining the time when "the property in the goods", i.e., the title, is to pass to the buyer. Personal Property Law, Section 100, provides in relevant part as follows:

> "Rule 1. Where there is an unconditional contract to sell specific goods, in a deliverable state, the property in the goods passes to the buyer when the contract is made, and it is immaterial whether the time of payment of the time of delivery, or both, be postponed."

That is exactly the situation under scrutiny, i.e., the parties had contracted to sell the specific shares of stock so that, pursuant to the above cited statute, the title passed when the contract was made.

To the same effect see Williston on Sales, Rev. Ed. (1948), vol. 2, p. 14, Section 264:

> "(T)he law is now well settled in accordance with the rules of the Sales Act, both where the Act is in force and under the common law, that the property is presumed to pass when the contract is made if the goods are identified, and nothing remains to be done other than the delivery of the goods and payment of the price."

In the instant situation, the stock was certainly specified, and the only thing that remained to be done was the payment of the agreed price and the delivery of the stock.

It is provided in P. P. L., Section 134, that the seller has a right to retain the subject matter of the sale, as security for the price, notwithstanding the fact that the title of the stock passed to the buyer as aforesaid. That section provides in relevant part as follows:

> "1. Subject to the provisions of this article, notwithstanding that the property in the goods may have passed to the buyer, the unpaid seller of goods as such has (a) a lien on the goods, or right to retain them for the price while he is in possession of them."

Pursuant to P. P. L., Section 133, 1(b), the taxpayer was in the position of an unpaid seller, having received an unconditional negotiable instrument which was defaulted upon and he has exercised his right under P. P. L., Section 144, to sue the purchasers for the unpaid balance due on the notes. That suit resulted in a judgment for the taxpayer.

Commensurate with his right to sue for the unpaid balance of the purchase price, the taxpayer had the duty to perform his part of the bargain by transferring possession of the stock to the purchaser. See P. P. L., Section 144(2), which, in addition to affording the taxpayer the right to sue for the price, provides as follows:

> "But it shall be a defense to such an action that the seller at any time before judgment in such action has manifested an inability to perform the contract for the sale on his part or an intention not to perform it."

See also Doyle's Main Motors, Inc. v. Davis, 118 N.Y.S. 2d 867, in which the Court held that, pursuant to Personal Property Law 100, Rule 1, quoted above, the property in the specific goods passed at the time the contract was made, "although the time of payment and the time of delivery were postponed." The seller in that suit, as in the instant situation, had a lien on the goods and the right to retain it for the price. The Court further held that the purchaser-defendant could obtain a direction from the Court that the specific goods be transferred to him. Obviously, it would be unfair to allow the seller to sue for the price and not require him to deliver the property which was the consideration for the price.

Accordingly, even though the taxpayer had retained possession of the stock until his judgment was compromised, the title passed upon the making of the contract, and the "sale" therefore occurred in 1961. See

also Italy Bank v. Merchants National Bank, 113 Misc. 314, 185 N.Y.S. 43; Chandler Motor Car Company v. United Fruit Company, 127 Misc. 432, 216 N.Y.S. 413.

The reports are replete with tax cases in which it is held that even if title did not pass upon the making of the contract (which is even stronger than the instant situation in which title did pass as is shown above) the "sale or other disposition" of property was deemed to have occurred in the year that the contract was made.

In Dakota Creek Lumber & Shingle Company v. Commissioner of Internal Revenue, 26 B.T.A. 940, an agreement to sell was entered into in 1923. Part of the price was paid in that year, but title was not to pass and did not pass until 1924, upon the payment of the balance of the purchase price. The Court, after an extensive review of the cases, concluded:

> "(F)or income tax purposes the sale was completed in 1923, regardless of the fact that title had not passed to the vendee."

For the same proposition see Davidson & Case Lumber Company v. Motter, 14 F. 2d 137; J.T. Pittard, 5 B.T.A. 929; Seletha O. Thompson, 9 B.T.A. 1342; Old Farmers Oil Company, 12 B.T.A. 203; Grace Harper Lumber Company, 14 B.T.A. 996; Bailey, et al., 18 B.T.A. 105; Federal Development Co., 18 B.T.A. 971; Harris Trust & Savings

Bank, 24 B.T.A. 498; W.H. Hay, 24 B.T.A. 96. See also Pacheco Creek Orchard Company, 12 B.T.A. 1358, in which it was held that although the contract of sale provided that the deed was not to be delivered until payment was complete, the sale for income tax purposes could not be deferred until title passed.

Accordingly, it is clear that sums received by Taxpayer were proceeds received in connection with the sale of his Graphic Arts stock. Under the authorities cited hereinabove, such a sale occurred when the agreement was made in 1961. The only question, then, is whether the character of those proceeds changed by virtue of subsequent events. Those events included the default on the part of the purchasers in the payment of the balance of the purchase price, the Taxpayer's lawsuit against the purchasers to compel payment, the judgment in favor of the taxpayer requiring payment by the purchasers, the payment on account of said judgment, and the delivery of the stock.

The Commissioner claims that the $95,000 received by the Taxpayer prior to the default and the lawsuit, constituted a forfeiture by the purchaser and that at the point of default the purchaser was entitled to keep both the $95,000 and the stock. As the Commissioner states at pages 12 & 17 of its brief, the payments made to the taxpayer were "in the nature of liquidated damages." Thus the Respondent argues that the amounts

received by the taxpayer were not in connection with the "sale" of any stock since the purchaser was entitled to keep both the money and the stock. To the contrary, neither the law of New York nor the agreement between the parties entitled the purchaser to keep both the $95,000 and the stock. The only circumstance under which an unpaid seller of stock can retain both the stock and the payments made prior to default, is where there is an agreement that such payments constitute liquidated damages. There was no such agreement in this case. In A.M. Johnson, 32 B.T.A. 156, the agreement between the seller and the purchaser was that if the sale was not consummated within a stipulated period, then the stock which had been placed in escrow along with a $45,000 deposit was to be turned over to the seller as liquidated damages. In accordance with that agreement, and as a consequence of the default, the stock was returned to the seller and the $45,000 was forfeited. The Court held thus at page 161:

> "The payment was made not because of the disposition of a capital asset. It was a payment of liquidated damages for failure to complete a sale.
>
> "After the payment, the petitioner had exactly the same capital assets as before the transaction was entered into."

Likewise, in Binns v. United States, 254 F. Supp. 889 (1966), aff'd 385 F. 2d 159 (6th Cir. 1967), it was held that monies forfeited as a

result of an agreement that such monies would constitute liquidated damages was held to have been ordinary income. After the default in that case, the purchaser wrote to the seller, stating:

> "It is requested you accept the $75,000 down payment as forfeited and release (the purchaser) from any further liability in this matter."

The Court found that the sellers "agreed to release the purchasers from further liability and accepted the down payment."

The Court further held:

> "It seems clear that, if the original sales contract had contained a provision that failure to pay the balance of the purchase price as agreed would result in the return of the stock to the sellers and that the down payment would be forfeited as liquidated damages discharging purchasers from further liability, no supportable argument could be made that such sum in lieu of liquidated damages did not constitute income to the sellers. Johnson v. Commissioner, 32 B.T.A. 156 (1935); Boatman v. Commissioner 32 T.C. 1188 (1959)."

The Circuit Court, affirming, pointed out that the sellers and the purchasers

> "...agreed to forfeit their down payment of $75,000 as consideration for their being released from further liability under the contract."

In the instant case, there was no such agreement that the $95,000

paid to the Taxpayer would be forfeited as liquidated damages in return for agreement by the seller that the purchasers would have no further liability. Indeed, the taxpayer sued the purchasers requiring that they fully perform the terms of their agreement to purchase the stock and the purchaser counter-claimed for moneys paid to the Taxpayer.

Again, in Myers v. Commissioner of Internal Revenue, 287 F. 2d 400 (6th Cir. 1961) it was held that monies paid to the taxpayer in partial payment for the sale of assets constituted ordinary income in light of a

> "...mutual agreement with vendee that the contract of sale was not be be carried out, and that they (the sellers) were to retain that part of the purchase price which had already been paid them..."

Again, in Harold S. Smith, 50 T.C. 273, aff'd 24 AFTR 2d 69-6020, 418 F. 2d (9th Cir. 1969), certain sums were deposited in escrow under a contract relating to the sale by the taxpayer of certain stocks and other property. When the buyer defaulted, the taxpayer sued to recover the deposited funds and the parties eventually effected a settlement. In holding the sums received by the taxpayer to be ordinary income, the Court pointed out:

> "The contract provided that if the buyer should fail to pay the balance of the price or to perform the obligations assumed,

> the escrow holder was to pay over to the sellers the deposit <u>to be retained as liquidated damages for breach of contract</u> on the part of the buyer for failure to consummate the purchase.
>
> "In a number of cases we have held that where, <u>in a contract</u> to purchase the controlling stock of a corporation, or other property, a sum has been deposited to apply on the purchase price, or to be retained by or paid over to the seller as <u>liquidated damages</u> if the purchase is not completed, the amount so received by the seller when the purchase is not consummated is taxable as ordinary income. The seller in such cases has the same capital assets as before and had the deposited amount as well. A.M. Johnson, 32 B.T.A. 156, 161 (1935); Doyle v. Commissioner, 110 F. 2d 157 (C.A. 2, 1940), affirming 39 B.T.A. 940, certiorari denied 311 U.S. 658; Ralph A. Boatman, 32 T.C. 1188 (1959). See also Binns v. United States, 254 F. Supp. 889 M.D. Tenn. 1966), aff'd 385 F. 2d 159 (C.A. 6, 1967)."

Again, in <u>Ralph A. Boatman,</u> 32 T.C. 1188, monies received by a seller in connection with a defaulted sale were held to be ordinary income since the parties agreed that such sums would be liquidated damages which would relieve the purchaser of any further liability.

The escrow agreements in the instant case provided that upon the purchasers' failure to pay the balance of the purchase price on a stipulated date, then the stock which had been placed in escrow would be returned to the seller. (R.78-9). This provision merely protected

the seller's lien under Personal Property Law, Sections 133 and 134 (1). It did not give the seller the right to retain the monies as liquidated damages. Such provisions for liquidated damages must be clearly set forth in a contract. They can never be read into a contract by implication. In Winkelman v. Winkelman, 208 App. Div. 68, 203 N.Y.S. 63, the Appellate Division held:

> "Such a (liquidated damage) provision never is read into a contract by implication. Even in a case where the parties specifically agree to regard the amount as liquidated damages, if such amount is disproportionate to the damages actually sustained, the court will regard the provision as a penalty and limit the plaintiff to the actual damages. Ward v. Hudson River B. Co., 125 N.Y. 230, 26 N.E. 256."

See also People v. Condor of Americas, Inc., 43 Misc. 2d 899, 252 N.Y. 2d 619 (1964) in which it was again held that "a provision for liquidated damages is never read into a contract by implication".

Accordingly, upon the purchaser's default, the Taxpayer had the alternative of retaining the stock as security for the payment of the balance of the purchase price, or he could have rescinded the sale. Personal Property Law, Sec. 134. The choice of the latter alternative would have required him to tender back to the purchasers the $95,000 which he had been paid. Gilbert v. Rothschild, 80 N.Y. 66, 19 N.E. 2d 785. Rather than do that, the Taxpayer retained his possessory lien on the stocks and sued the purchasers for the balance of the price. He turned over the stocks when the purchasers paid a portion of the judgment

in accordance with a stipulation of settlement.

Accordingly, the contention of the Commissioner is based upon the premise that the Taxpayer could have retained the $95,000 and the stock. This premise is false. The Taxpayer did not have that alternative open to him. He either had to rescind the sale which would have required him to give back the money, or sue the purchasers for the balance of the purchase price, pursuant to Personal Property Law, Sec. 144, retaining the stocks to protect his security interest in them. Since there was no agreement that the sums paid would be liquidated damages, and since the Taxpayer affirmed the contract of sale by suing the purchasers for the balance of the purchase price, it is clear that the sums received by the Taxpayer did not constitute liquidated damages or a forfeiture, but rather constituted a portion of the price which the purchasers agreed to pay for the sale of the Graphic Arts stock. That being so, the Taxpayer is entitled to treat those sums on a capital gains basis. Indeed, the tax court below held

> "It is clear from the record in this case that the taxpayer was at all times ready and willing to deliver the stock sold to the purchasers upon payment of the notes. Under the laws of New York governing this transaction, it appears that 'Unless a different intention appears, ***

> Rule 1. Where there is an unconditional contract to sell specific goods, in a deliverable state, the property in the goods passes to the buyer when the contract is made and it is immaterial whether the time of payment, or the time of delivery, or both, be postponed. (NY Pers. Prop. Law, Sec. 100 [McKinney 1962])

See Rosenzweig v. Salkind, 158 N.Y.S. 2d 522 (Sup. Ct. 1956), reversed on other grounds 169 N.Y.S. 2d 213. (Sup. Ct. 1957), aff'd 183 N.Y.S. 2d 82 (1959).

Therefore, the ownership passed upon payment of the cash and execution of the notes, leaving petitioner with nothing more than a vendor's lien. See N.Y. Pers. Prop. Law, Sec. 134 (1)(a) (McKinney 1962); Newman v. United Distillers Co., Inc., 175 N.Y.S. 176 (Sup. Ct. 1919); Rosenzweig v. Salkind, supra. However, we need not go that far. As we view the facts in this case the respondent is in error. Petitioner, at all times, was attempting to complete the transaction. There was no forfeiture."

***

"When the purchasers failed to pay the notes when due, and after the expiration of each extension or new escrow set up by the petitioner, the petitioner could elect either to take back the stock and call the whole deal off or to file suit on the notes and be prepared to deliver the stock to the purchasers. See NY Pers. Prop. Law, Sections 134 & 144 (McKinney 1962); Solomon v. Van de Maele, supra. See also Doyle's Main Motors v. Davis, 118 N.Y.S. 2d 867 (Sup. Ct. 1963).

If petitioner had elected to terminate the agreement, not only would his right ultimately to collect on the notes be jeopardized, but he might be called upon to refund the cash payments which had been received by him because "a provision for liquidated damages is never read into a contract by implication ***." People v. Condor of Americas, Inc., 252 N.Y.S. 2d 619 (Sup. Ct. 1964); see also Winkelman v. Winkelman, 204 N.Y.S. 63 (Sup. Ct. 1924); cf. Pirman v. Kurtz, 45 N.Y.S. 2d 508 (Sup. Ct. 1943). "***"Recission can be effective only by returning or tendering back the consideration received." Gilbert v. Rothschild, 80 NY 66, 19 NE 2d 785 (1939), and cases there cited.

Obviously, it was to the advantage of the petitioner not to claim a forfeiture but rather to proceed with the collection of the notes, in which event the petitioner would have to be prepared to make delivery of the stock."

The taxpayer contends that the Commissioner cannot on this appeal raise an issue respecting the taxpayer's use of the installment method of reporting the gain on the sale of Graphic Arts stock in that it was not raised in the deficiency notice sent by the Commissioner which precipitated these proceedings, was not designated as an issue in the original brief submitted by the Commissioner to the tax court and was not passed upon by the tax court nor was such an issue even adverted to in the decision of the court below. In any event, it is clear that the taxpayer was entitled

to utilize the installment method to report the gain on the sale and that, in any event, the taxpayer can only be taxed on the amount of money received in the years in question.

The Commissioner's contention is based upon the claim that it is "impossible to calculate the ratable portion of each payment which represented gain" (Commissioner's brief, page 22). That contention is based upon the confused and misleading presentation of the facts made in the Commissioner's brief. As is set forth above, and as is summarized by the tax court, the payments made by the purchasers were pursuant to an agreement to pay $221,000 for taxpayer's stock. This agreement was modified in March, 1963 to increase the purchase price by $24,000. (R. 55, 56). Having received less than 30% in the year of the sale, taxpayer may utilize the installment method of reporting the gain in accordance with I. R. C. Sec. 453.

Even if the installment method is not used, the taxpayer can only be taxed on the amount of money or other property received in the years in question. I. R. C. Section 1001 provides:

> "(a) Computation of Gain or Loss. - The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over

> the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) Amount Realized - The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received . . . "

In accordance with the above-cited statute, the gain upon which a tax liability may be based is the money or other property received by the taxpayer in the years in question. Here, the taxpayer received cash in the amount of $95, 000, and three notes in the total amount of $126, 000, and, at a later date, a promise to pay an additional $24, 000. As stated in Mertens <u>Law of Federal Income Taxation,</u> Section 11. 06,

> "In the case of executory contracts of sale involving deferred payments evidenced only by the contract . . . the deferred payments provided for in the contract have ordinarily been included in income only when received."

See cases cited in <u>Mertens,</u> supra, No. 53. It is of prime importance to note that the buyers in the instant situation attempted for approximately three years to pay for the stock in accordance with their agreement, executed notes and checks which were defaulted upon numerous times.

As a matter of fact and reality, the oral promise to pay for the stock in accordance with the agreement (aside from the notes which will be discussed infra) was certainly not the equivalent of cash.

It is stated in Bedell v. Commissioner, 30 F. 2d 622, that

> "It is absurd to speak of a promise to pay a sum in the future as having a 'market value', fair or unfair."

It is even more absurd to consider as having a market value the notes and promises of the buyers in the instant case, whose history of lack of ability to meet their financial obligations is well known to all those who have dealt with them in recent years.[5] As stated in Mertens, supra, Section 11.05:

> "In these cases, some reliance is placed on the argument that unless the payments are represented by property or evidence of property which is presently disposable for cash without supporting evidence of value, the income should not be taxed in the year of sale unless there is then no property available for the payment of the tax which would be imposed on the transaction."

5. A proceeding was held in the Supreme Court, New York County to determine the priority of various creditors regarding a trust fund of which VardeMaele was a beneficiary. The records filed in that case reflect that claims were filed by Meadowbrook Bank, Bank of Nova Scotia, James Talcott, Inc., the Internal Revenue Service and six other creditors, totalling $424,246.70 plus interest approximating $250,000. The proceeding was entitled In Re Bankers Trust Co. and Joan VandeMaele as trustees of the trust agreement of Harry F. Guggenheim, New York Supreme Court Index No. 15083/1968.

In any event, the oral promise of the purchasers, which was made in 1961, obviously had no market value. Indeed, the judgment obtained by petitioner against the buyers in 1965 was finally compromised five years later, in 1970 (nine years after the agreement) by a payment of approximately 50% of the face amount of the judgment plus interest. (Ex. Vol. 20)

It is fundamental that it is only when a note is received as payment as distinguished from mere evidence of indebtedness, that it is regarded as the equivalent of cash and taxed at the fair market value. See San Jacinto Life Insurance Company, 34 B. T. A. 186; Frank Kuhn, 34 B. T. A. 274; Schlemmer v. United States, 94 F. 2d 77. In Schlemmer, supra, a corporation issued notes to certain officers for salary which it was not in a position financially to then pay. The Second Circuit (L. Hand, J.) held:

> "The only actual testimony was that the note was not taken as payment, but only as more permanent evidence of the debt. Indeed, it is not at all clear that it would have been a cash item even if it had in fact been taken as payment. It did not change the substance of the debt - not being endorsed or secured - and although it was more readily disposable, that single incident was scarcely enough. There must be more than difference in the mere form of property to justify a charge of income. Weiss v. Stearn, 265 U.S. 242, 44S. Ct. 400, 68 L. Ed. 1001, 33 A.L.R. 520

> But we need not stand on that; in any case, since it was not taken as payment it could not be treated as cash; the old debt remained, the note was no more than added security. Sass v. Commissioner, 12 B. T. A. 156 (Semble); Merren v. Commissioner, 18 B. T. A. 156; Humphrey v. Commissioner, 32 B. T. A. 280

As is the case in the instant situation, the Court there pointed out that the notes were never paid and the makers of the notes at the time of the issuance thereof were in poor financial condition.

In Robert J. Dial, 24 T. C. 117, a corporation which could not pay salaries because of financial difficulties issued its negotiable notes to certain officers, which note were secured by a second mortgage and were interest bearing. The Court there held:

> "We are convinced that the only intent which prompted the issuance of the notes to (taxpayer) was that a plan be adopted providing for a funding of the debts owed to them. The notes were never meant to be anything more than additional security for the principal debts, for nobody intended them to be payment thereof. We are satisfied that this is true even though . . . the notes or bonds received by them were secured obligations."

The Court further held that:

> ". . . The necessary fact necessary to support (the Commissioner's) determination is absent, namely that the negotiable instruments were received in payment."

Again, in Virginia W. Stettinius Dudley, 32 T. C. 564, aff'd per curiam 279 F. 2d 219 (C. A. 2d, 1960) it was held that notes were not taxable even though they were secured. (The case at bar is an a fortiari situation, since the notes were unsecured). There the Court held:

> "Petitioners are correct, however, in their contention that final payment of the note should be reported as income in 1949 rather than 1948. Upon this record it appears that the note was given to evidence indebtedness of $350,000, not in payment thereof. Throughout this transaction, the promoting parties were interested in cash payment by United, not in its promise to pay . . . (the Commissioner) does not contest the fact that United was in tenuous financial condition at all relevant times so as to render questionable the value of any promise it might give. Although its note was secured, we do not know the value of the security . . . Finally, the escrow arrangement itself, whereby the note was in terms payable to the escrow agent who retained possession of the note and received all payments thereon, indicates that the note was not available to the (taxpayer) as the equivalent of cash in any practical or commercial sense, nor was it intended to be. It follows that the fair market value of the note, if any, was not includible in the income but that payments on the note should have been reported as received. Schlemmer v. United States (supra); Robert J. Dial (supra) . . . "

In the instant case, the unsecured notes were considered evidence of the indebtedness rather than as payment. That this is so is clear in light of the fact that it would have been impossible to discount or

otherwise transfer the notes for value and the fact that no other evidence of indebtedness existed. The taxpayer, in 1961, wanted evidence of the indebtedness and therefore requested that it be put in the most convenient form, which was notes. The stock was to have been transferred only upon payment of the notes. Consequently the buyers would have only been liable on their notes in the event that the taxpayer delivered the stock. As is pointed out above, after the buyers' default in the payment of their notes in June, 1962, the taxpayer subsequently had the rights of an unpaid seller pursuant to the provisions of the Sales Act, which included the right to sell the stock elsewhere and sue the buyer for damages. Had the taxpayer chosen that option, he could not have collected on the notes. It would consequently be unfair to impose a tax liability upon notes which were not payable in all events. Indeed, it has been held that negotiable notes, the payment of which is contingent, ordinarily have no fair market value and accordingly it has been held that they are not the equivalent of cash. Homestead Woolen Mills, B. T. A. Memo Op. Dkt. 103131 (1942); J. A. Williams, 28 T. C. 1000 (1957)

Accordingly, the petitioner should have the right to report the gain on the installment basis. In any event, he is only required to report the amount of cash received in each of the years involved.

POINT II

THE TAX COURT'S FACTUAL FINDINGS THAT AN ENTERTAINMENT FACILITY WAS USED PRIMARILY FOR BUSINESS PURPOSES AND THAT THE TAXPAYER MET THE SUBSTANTIATION REQUIREMENTS OF SECTION 274, ARE NOT CLEARLY ERRONEOUS.

In Point III of it's brief, the Commissioner contends that the Tax Court made errors of law "in failing to apply the applicable requirements of Section 274 of the Internal Revenue Code of 1954". However, it is apparent from the Tax Court's decision that it was distinctly aware of and was applying the standard set forth in Section 274, the relevant portions of which section were set forth at length in the Tax Court's decision (R. 172-174), including the dual requirements of Section 274(a) (1) (B) "that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business" (R.172). Likewise, the Tax Court, in its decision, spelled out the substantiation requirements set forth in Section 274d, to the effect that a deduction will not be allowed "unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement "the relevant amount, time, place, business purpose and business relationship.

Applying the statutory standards, the Tax Court held:

> "The petitioner is a long time sailing enthusiast, having begun to sail sometime in the 30's and having gained recognition as a sailor by winning the Bermuda race and others. The petitioner raced his boat in several well known races each year, including Bermuda race and the Martha's Vineyard Race. At such times, various members of the crew were either clients of petitioner or were possible sources of business.
>
> The petitioner maintained no formal records showing the guests entertained on the boat. However, in his office, petitioner maintained diaries and telephone records from which schedules were prepared showing the occasions upon which petitioner entertained persons on his boat from whom or through whose efforts petitioner obtained legal business.
>
> For the taxable years 1961 and 1962, the parties have agreed that 60 percent of the expenses incurred in the maintenance and operation of the boat were allowable as business expenses. The petitioner has substantiated a similar use for the taxable years 1963 to 1965, inclusive. (R. 163-164)
>
> * * * * * * * * *
>
> With respect to the question whether the facility was "primarily" used by the petitioner for the purpose of "entertaining" clients and others who might be instrumental in forwarding litigation to the petitioner in furtherance of his business, petitioner submitted a list compiled from his office records showing the

names of various guests entertained aboard the yacht. In a substantial number of instances, the petitioner testified with respect to the relationship of the named individuals to an actual or potential source of litigation. While the petitioner did not account for all occasions on which the yacht may have been used by him, in our opinion such records were adequate to meet the test of primary use with respect to the facility. LaForge v. Commissioner, 434 F. 2d 370 (C.A. 2, 1970), reversing 53 T.C. 41 (1969); William F. Sanford, 50 T.C. 823 (1968), affirmed per curiam 412 F., 2d 201 (C.A. 2, 1969), certiorari denied 396 U.S. 841 (1969).

Having met the primary use test with respect to the facility, it then becomes necessary to determine the specific amount or cost which the petitioner is entitled to deduct as a business expenditure under section 162.

In this respect, the actual amounts expended are not in question. The parties have agreed upon the costs of operating and maintaining the yacht during the years in question. For the most part, these were general expenses which can only be chargeable on the basis of the ratio of business use of the facility to its total use. In the mind of the petitioner, it was all business. With that, we must disagree. We are satisfied, however, that the petitioner has substantiated his rights to the deduction of not less than 60 percent of such costs for the taxable years 1963 to 1965, inclusive. Our conclusion is buttressed by reference to the fact that this was the basis agreed upon by the parties for the taxable years 1961 and 1962 in the absence of the more specific requirements of section 274 with respect to the maintenance of records. While it must be admitted that a more precise result could have been achieved if petitioner had kept a formal log, comparable information supplied from contemporary records is an acceptable substitute. LaForge v.

Commissioner, supra."(R. 174-176)

It has been held by this Court in Hughes v. Commissioner of Internal Revenue, 451 F. 2d 975 (C.A. 2, 1971) that a Tax Court decision regarding whether the taxpayer has met the requirements of IRC Section 274 constitutes a factual finding which can only be over turned by this Court if "clearly erroneous", in accordance with the standards of Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278, 291, 80 S. Ct. 1190, 4 L. Ed. 2d 1218 (1960). This Court, in the Hughes decision, stated:

> "The United States Court of Appeals have exclusive jurisdiction to review decisions of the Tax Court in the same manner and to the same extent as decisions in the district courts in civil actions tried without a jury. Int. Rev. Code of 1954, Section 7482(a). Where the trial has been by a judge without a jury, the judge's findings must stand unless 'clearly erroneous'. Fed. R. Civ. P. 52(a), In Duberstein the Supreme Court applied to the review of Tax Court fact-finding decisions the "clearly erroneous" test of United States v. United States Gypsum Co. 333 U.S. 364, 395, 68 S. Ct. 525, 542, 92 L. Ed. 746 (1948), i.e., "(a) finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed".

See also, Long v. Commissioner of Internal Revenue, 277 F. 2d 239, 241 (C.A. 8, 1960), in which it was held that the question of whether expenditures are ordinary and necessary business expenses is a question of fact, and that a Tax Court finding on that issue is presumably correct, and will not be set aside unless clearly erroneous.

The evidence presented with respect to the deduction taken by the taxpayer in the years 1963, 1964 and 1965 for the expenses of maintaining a sailing yacht, was sufficient to justify the Tax Court's findings. Taxpayer acquired the boat in 1958 (R. 134). It is a 46 ft. sailing sloop (R. 87-88), which the taxpayer testified was used primarily for entertainment and promotion with the idea of creating clients and obtaining legal retainers (R. 87). Taxpayer testified that the boat was used at least 80% of the time for that purpose, that at no time has his family in any way participated in the boat, that neither his wife nor children ever used the boat and that he has used it solely for business and prospective clients (R. 67). He further testified that he does not belong to a golf club or any other clubs for the purpose of entertaining clients, and that all entertainment done by

him has been in the yachting area (R. 88). Taxpayer stated that he can trace the majority of his fees as coming from people that he has entertained on the boat (R. 88). He further testified that he can take any where from 4 to 6 guests on the boat, normally, but at times he has taken up to as many as 20 to view the America Cup Races, at which times he hires persons to serve drinks (R. 89).

Taxpayer pointed out that the boat is a famous one, having won many races, both during and prior to his ownership, including the Bermuda Race, that it sleeps 6 people and has a complete galley and excellent bar (R. 89-90). He pointed out that the boat seems to provide more fascination than a large luxury power boat, since, although it does not have provisions for certain basic comforts, people like the adventure (R. 89-91). Taxpayer further testified that 20% of the time that the boat was not used solely for entertaining clients, he raced the boat, which resulted in publicity, such as being on the cover of Skipper Magazine, and other yachting magazines, the New York Times, and National Geographic, all during the years in question (R. 92). During the weekends of the summer months which are best suited for entertainment, which includes approximately 12 weekends, the boat is used solely for entertainment purposes (R. 98-99). Other than those summer months, the boat was used 4 to 6 times in the years

in question for racing (R. 125, 135). The usual crew for racing is 8 (R. 127). Taxpayer testified that he has obtained substantial business from members of his crews, including the largest case in the office (R. 128-129). The crews are all unpaid. They are crewing for pleasure, so they are in effect guests (R. 128). Taxpayer has doctors, aviators, people from all walks of life, as members of his crew, and pointed out that one of his crew has paid a substantial retaining fee to represent his Company in a large claim (R. 128). The races last from 1 to 2 days (R. 135). Taxpayer pointed out that there are no races during the summer and that is when he did most of his entertaining (R. 141). Taxpayer began sailing in the 1930's and has won many races, including the Bermuda Race (R.141). Taxpayer listed many crew members some of who are responsible for large fees (R. 141-142, 105).

Taxpayer's oral testimony was corroborated by records kept by his office which were summarized in various exhibits which are referred to below. Each of the summaries was based upon information contained in telephone message books and diaries which were brought to Court and were expressly made available for inspection and verification by the Appellant and the Court. The Court overruled the Commissioner's objection to the admission of the summaries

specifically pointing out that the Commissioner could and indeed did view the original records upon which they were based (R. 95-97).

Exhibit 30 (Ex. Vol. 95) is a summary for the year 1963 and contains the names of various persons who were on the boat on different occasions, 7 of which are stated to be for entire week-ends. Here again, a review of the dates listed on the schedule reveals that the boat was used for entertainment purposes virtually every weekend that it was in the water. The same is true with respect to the summary for 1965 (Ex. Vol. 98) in which year the boat was used on 23 different occasions for entertainment, 5 of which times were for entire weekends.

Although the Court indicated that it could assume that the persons listed on the summaries as having been entertained on the boat are actual clients or reasonable prospects (R. 106), the tax-payer submitted Exhibit 33 (Ex. Vol. 100) which is a schedule of fees earned as a result of entertainment on the facility (R. 116-117, 119), pointing out that the schedule includes a statement of only those people on the boat that have turned into profitable clients,

with a statement of the amounts received from each to date. During the year 1963 in which the taxpayer deducted approximately \$9,000 for use of the facility, he grossed \$315,066.31 over the period 1963 through 1971 from persons who were entertained on the boat in 1963. In the year 1964 the taxpayer deducted approximately \$6,800 for use of the boat and grossed \$74,955 for the period 1965 through 1971 from persons who were entertained on the boat during the calendar year 1964.

Likewise, the taxpayer pointed out the affiliation with a number of persons who were entertained on the boat, as reflected by the summaries, included heads of large companies, lawyers (R.128) and other persons of stature (See Ex. Vol. 100-103, & 95-98).

Regulations Section 1.274-2(4) (i) provides that a facility used in connection with entertainment "shall be considered as used primarily for the taxpayer's trade or business" and that "all of the facts and circumstances of each case" should be considered. The Regulation also provides that "it is the actual use of the facility which establishes the deductibility of the expenditure with respect to the facility, not its availability for use..." In the instant case, the taxpayer has shown that on virtually every weekend that the boat was available for use at all (weekends being the only time that the

boat is used), the taxpayer entertained various persons who eventually paid him fees.

The same Regulation states that the use of a facility by the taxpayer's family "will be considered in determining whether business use of the facility exceeds personal use". In the instant case the taxpayer testified that his family did not use the facility at all (R. 88).

Regulation Section 1. 274-2(4)(iii) provides that a yacht or other pleasure boat shall be deemed to have been used primarily for use in the trade or business if the taxpayer establishes that "more than 50% of the total calendar days of use of the facility by . . . the taxpayer during a taxable year were days of business." In the instant case the taxpayer's records and testimony thus reflected the use of the boat for business purposes as follows:

> In the year 1963 - 23 calendar days (see Exh. 30 which in some cases refer to weekend use which is counted as 2 days).
> In the year 1964 - 33 calendar days
> In the year 1965 - 28 calendar days

There are 18 weekends (or 36 calendar days) during the months of June through September when the boat was available for use by the taxpayer, assuming, of course, that the weather permitted. Even if

the boat was used on each of those 36 days, the number of calendar days which the taxpayer proved that the boat was used solely for entertainment purposes well exceeds the 50% limitation of the regulation, being 63%, 91% and 78% for the respective years. Particularly in light of the weather conditions, which it would have been impracticable for the taxpayer to have proved at this point, it is clear that the Tax Court had sufficient evidence to sustain its findings and that they were not clearly erroneous.

The Commissioner, in his brief, takes the broad position that the generally stated requirements in Section 274(a)(1)(B) that the use of the facility must be "directly related to the active conduct of the taxpayer's trade or business" should be read to require the disallowance of expenses of a facility which is used for the generation of good will and the obtaining of new business. In support of that position, the Commissioner cites Hippodrome Oldsmobile, Inc. v. United States 747 F 2d 959 (C.A. 6, 1973) in which the taxpayer, an automobile agency, sought to deduct the expenses of a pleasure boat which was used for the purpose of entertaining past and future customers to

obtain business. Holding that the deduction was not proper, the Court of Appeals pointed with emphasis to District Judge's finding that while the boat was used, a representative of the automobile agency would not initiate business conversation but would wait for the guests to mention the product to the host. As the Sixth Circuit put it, "the company customers entertained (on the boat) were not subject to any specific exposure to taxpayers products or suggested that they buy them while being thus entertained". Contrary to the Commissioner's contention, section 274 was not intended by Congress to do away with the allowance of deductions for entertainment on facilities which had as its purpose the generation of good will for the purpose of obtaining new business. In explaining the intention behind the use of the words "directly related to the active conduct of the taxpayer's business", (and the "associated with"language) the Senate Finance Committee stated that pursuant to that language:

> "the taxpayer must establish that the incurring of the expenses relating to the entertainment activities was directly related to or associated with his effort to obtain new business or to encourage the existing business relationship". Sen. Rep. No. 1881, 87th Cong., 2 sess. p. 28.

This is not a situation akin to that which was presented in Hippodrome. An attorney is forbidden by the Code of Ethics from advertising, so that the major way of obtaining new business is through exposure to persons who might have need of legal services, and the developing of relationships from which business may flow. Such exposure is made available and enhanced through entertainment. To put it in its baldest terms, this case is distinguishable from Hippodrome in that there the taxpayer conceded that the persons entertained were not subject to specific exposure to the taxpayer's products, while an attorney who is entertaining a prospective client is, in essence, trying to sell himself. Indeed, this Court has sanctioned the entertainment facility deductions by a professional man (a doctor) for club dues, which are considered by the statute to be a "facility" expenditure,[5] and other entertainment expenses which were incurred by the professional man in an effort to generate good will and obtain business LaForge v. Commissioner 434 F. 2d 370, 373 (C.A. 2, 1970).

5. I.R.C. Section 274 (b) 2 (A)

Nor does D. A. Foster Trenching Co., Inc. v. United States 473 F. 2d 1398 (Ct. Cl. 1973) stand for the general proposition that the expenses of an entertainment facility used for the generation of new business are non-deductible. In that case, the taxpayer, who was engaged in underground construction work for utility companies in various states, maintained a fishing boat. It was found, as a factual matter, that on a majority of occasions that the boat was used, it was used by the taxpayer's business customers, suppliers, and other associates, without the presence of any employee of the taxpayer. The Court of Claims thus held, on the basis of this finding,

> "that the taxpayer in the case before us could not make an argument that the entertainment contains any advertising advantage and that since the taxpayer's employees were not on the boat during its use by the taxpayer's customers, it could hardly be said that the facility was used for activities which were 'directly related to the active conduct' of the taxpayer's trade or business".

The distinction between D. A. Foster Trenching Co., Inc. v. United States supra and this case thus parallels the distinction with Hippodrome, supra. When a professional man, who is banned from outright advertising, is involved in entertainment of prospective clients, he is in fact trying to sell himself. Indeed, the Senate Finance Com-

mittee, in discussing the general policies being reflected in Section 274, acknowledged the importance of encouraging the allowance of expenses which

> "...serve to increase business income, which in turn produces additional tax revenues for the Treasury. If valid business expenses were to be disallowed as a deduction (particularly expenses associated with selling functions), there might be a substantial loss of revenue where business transactions are discouraged or where they fail to be consumated".

The Senate Finance Committee further stated that

> "if deduction is claimed for any expense for 'entertainment, amusement or recreation', the facts and circumstances of each particular case will determine the extent of which the expenses will be disallowed". S. Rep. No. 1881, 87th Cong., 2d sess (1962), reprinted in Vol. 2, U.S. Code Cong & Adm. News, at 3327-30.

Indeed, the consideration of each case in terms of its own facts and circumstances is a Congressional policy which is reflected in the use of the general language in Section 274, which contains the general guide line that the entertainment or facility be used for activity "directly related to the active conduct of(the taxpayer's) trade or business". In view of the substantial evidence reviewed above, it can-

not be said that the Tax Court's findings that the taxpayer satisfied the statutory requirement was "clearly erroneous". The same is true with respect to the lower courts finding regarding the substantiation requirements of Section 274(d). The bulk of the cases cited by the Commissioner which impose a strict record keeping obligation on the taxpayer, involve the substantiation of the amount of expenses, which in this case is not in dispute (R. 171).[6] Moreover, the Commissioner takes the untenable position that Section 274(d) requires a taxpayer to establish "in respect of each use of a facility the precise amount of the expense claimed" (Commissioner's brief, p. 33). Indeed, the Commissioner contends that the taxpayer must "establish the business purpose of each expense... in respect of each occasion of use for which he claims a deduction". He states that "in no other manner is it possible to determine the allocable portion of the total expenses which would be properly attributed

6. See e. g. Steel v. Commissioner 437 F 2d (1971) where the taxpayer had no records of expenses, cancelled checks or other documentary evidence; Fiorentino v. Commissioner 29 T. C. M. 1445 (1970), supp. opinion 29 T. C. M. 1665 (1970), aff'd. 455 F 2d 1406, (C. A. 2, 1970), where the records were not prepared at or near the time of the use of the facility, and the taxpayer did not have records of all business trips; see also, Nicholls, North, Buse Co. v. Commissioner, 56 T. C. 1225 (1971), also cited by the Commissioner, where the testimony regarding the business use was held to have been based on "conjecture" rather than "clear memory".

to deductible business purposes" (Commissioner's brief pgs. 33-34). Such a requirement would be virtually impossible of fulfillment, where you are dealing with the maintenance of a facility such as a boat, and such expenses as maintenance and depreciation are clearly not susceptible to the kind of proof which the Commissioner contends is required. Indeed, in LaForge v. Commissioner, supra, it was held that club dues were deductible as a facility expense to the extent of:

> "...that portion of the dues which corresponds to the taxpayers actual use of the facility for business entertainment. A taxpayer may deduct that fraction of the total dues that corresponds to the percentage, which the taxpayers expenditure for business meals taken at the club represent, of his total yearly expenditure for food and beverages purchased at the club".
>
> * * *
>
> The club dues represent the cost of taxpayer's access and access of his business guests, to the entertainment facility. Because the taxpayers presence was the prerequisite to the Tax Court's finding that his country club entertaining was in fact business entertaining, the cost of taxpayers access was 'directly related' to his practice within the meaning of Section 274 (a)(1)(B)."

There is a clear analogy between a doctor's use of a country club facility to further his practice, the expenses of which were allowed by this Court in LaForge v. Commissioner supra. ,and an attorney who entertains on a facility. The Commissioner's broadside attack on the use of a facility for generating new business finds no basis in the statute.

It was pointed out in Hughes v. Commissioner, supra. that Section 274(d) requires substantiation "by adequate records or by sufficient evidence corroborating his own statement", the amount, time, place and purpose of the expenditures. The amount was stipulated to below, the taxpayer having had complete records thereof; the time of the entertainment was recorded in the taxpayer's diaries and other records which were examined by the Commissioner in Court and were summarized in the schedules presented to the Court; the place of entertainment was the facility, and the substantiation with respect to the purpose of the entertainment was provided by the taxpayer's testimony as well as the records reflecting the fees earned from the persons entertained on the boat. As previously stated, this evidence was deemed by the Tax Court to be sufficient and it could not be said that its factual finding is "clearly erroneous".

The Commissioner further contends that the requirement in Section 274 (d) that the taxpayer must establish "that the facility was used primarily for the furtherance of the taxpayer's trade or business", should be read to require the keeping of minute by minute logs reflecting that more than 50% of the total use of the vessel was for business purposes. No such requirement can be found in the statute. In light of the testimony and documentation reviewed above as to the business use of the boat on 23 calendar days in 1963, 33 calendar days in 1964, and 28 calendar days in 1965, and the fact that there are 18 weekends (or 36 calendar days) during the fair weather months of June through September that the boat is used, it is clear that the Tax Court was not "clearly erroneous" in finding that the taxpayer had presented sufficient evidence of compliance with the primary use requirement of Section 274.

The Commissioner makes the repeated claim in his brief that the Tax Court "premised its decision" allowing taxpayer to deduct 60% of his boat expenses for the years 1963 through 1965, on a settlement between the parties relative to the years 1961 and

1962 in which years the requirements of Section 274 were not in effect (Commissioner's brief p. 32). The Commissioner states that the 60% tax "was simply adopted by the Tax Court on the basis of the settlement pertaining to the pre-Section 274 years" (Commissioner's brief p. 35). To the contrary, the Tax Court, in its decision pointed out that the agreement pertained to years in which there was "the absence of the more specific requirements of Section 274 with respect to the maintenance of records" (R. 175-176).

CONCLUSION

In light of the above, the decision of the Tax Court should be, in all respects, affirmed.

Respectfully submitted,

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JULY, 1974

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing three copies thereof on this 31st day of July, 1974, in an envelope with postage prepaid, properly addressed as follows:

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